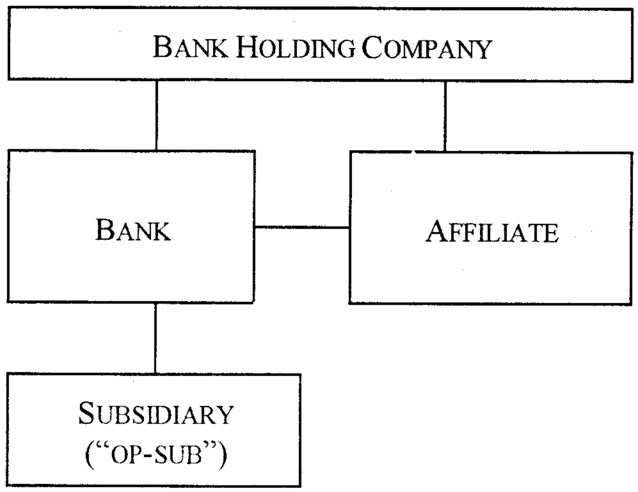
SUBSIDIARIES v. AFFILIATES:

QUESTIONS AND ANSWERS

February 11, 1999

1. What's the difference between a subsidiary and an affiliate of a bank?

A "bank holding company" is a company that owns a bank. (For tax and other reasons, most U.S. banks are owned by holding companies.) An "affiliate" of a bank is a separately incorporated entity owned by the same bank holding company. A "subsidiary" of a bank is a separately incorporated entity owned by the bank itself.



To a customer, or even a financial analyst, affiliates and subsidiaries are generally indistinguishable. Each can share employees with the bank. Each can have reporting lines that overlap with those of the bank. Each can operate under the same risk management and strategic planning system as the bank. For public financial reporting purposes, each typically has its assets and liabilities consolidated with those of the bank in the holding company's consolidated financial statements.

For a financial services firm that includes a bank, the affiliate and subsidiary structures are both reasonable options. Thus, for example, many such firms operate mortgage companies as affiliates of banks, while many others operate them as subsidiaries of banks.

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2. What's the Treasury's position on allowing subsidiaries to engage in financial activities?

We would allow a subsidiary or an affiliate to engage in any financial activity — subject to functional regulation and a rigorous set of safety and soundness safeguards.

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3. ***Would the risks of activities conducted in a subsidiary adversely affect the safety and soundness of the parent bank?***

Under a fundamental, longstanding, and uniform rule of corporate law, a parent corporation is not liable for the obligations of a separately incorporated subsidiary. If the subsidiary fails, the parent stands to lose no more than its investment in the subsidiary. The parent can be held liable for the obligations of a subsidiary — through a process known as "piercing the corporate veil" — only under extraordinary circumstances, such as fraud by the parent.

The Treasury would impose rigorous safeguards on a bank's exposure to a subsidiary engaged in new financial activities (as would H.R. 665, the LaFalce bill).

- The bank would have to remain well capitalized (i.e., in the highest regulatory capital category) and well managed, and would face sanctions if it failed to do so.

- Every dollar of the bank's equity investment in the subsidiary would be deducted from the bank's capital — and the bank would have to remain well capitalized even after the deduction. Thus, even if the subsidiary were to fail and the bank's equity investment in it were to prove a total loss, the bank would still be well capitalized. The capital-deduction rule would, in effect, require the bank to be able to lose its entire equity stake in the subsidiary and still remain well capitalized.

- A bank could not make an equity investment in a subsidiary that would exceed the amount that the bank could pay as a dividend.

- Sections 23A and 23B of the Federal Reserve Act would be amended to restrict any loans or other extensions of credit from the bank to the subsidiary, any guarantees by the bank for the benefit of the subsidiary, and any purchase of assets by the bank from the subsidiary. Thus the total amount of these transactions with the subsidiary could not exceed 10 percent of the bank's capital, and the total amount of these transactions with all of the bank's subsidiaries and affiliates combined could not exceed 20 percent of the bank's capital. All such transactions between the bank and the subsidiary would have to be on market terms and fully secured by specified types of high-quality collateral.

Under these safeguards, there would be *no economic difference* between conducting an activity in a subsidiary and conducting it in an affiliate — apart from such benefits of the subsidiary as providing greater protection to the FDIC and diversifying the bank's earnings (as explained in response to Question 4).

- The rules governing extensions of credit, guarantees, and asset purchases would be *exactly the same* for subsidiaries as for affiliates.
- The rules governing equity investments would be *equivalent*. A bank could invest in a subsidiary only the amount that it could pay as a dividend (e.g., to its parent holding company). And the bank would have to deduct from its own capital the entire amount of the investment. Thus, if the bank made an equity investment in a subsidiary, the economic result would be the same as if the bank had paid a dividend to its parent holding company and the holding company had invested the proceeds in an affiliate. In either case, the amount invested would no longer count as part of the bank's capital.

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4. How would allowing new financial activities in subsidiaries affect the federal deposit insurance funds?

Allowing new financial activities in subsidiaries would help protect the deposit insurance funds. For the reasons noted in response to Question 3, allowing new financial activities in subsidiaries would pose no greater risk to banks than allowing them in affiliates. And it would actually *increase the good assets available to the FDIC to resolve troubled banks and protect their insured depositors* — whereas forcing activities into affiliates would tend to decrease those assets. A bank's ownership interest in a subsidiary is an asset of the bank. If the bank gets into trouble, the bank can sell its stake in the subsidiary and use the proceeds to replenish its regulatory capital. And if the bank fails, the FDIC can sell the bank's stake in the subsidiary and use the proceeds to reduce any loss that the FDIC would otherwise incur in protecting the bank's insured depositors. By contrast, the FDIC generally has no authority to sell assets of a failed bank's nonbank affiliates.

The FDIC, which has a paramount interest in protecting the deposit insurance funds, has emphasized that the subsidiary structure better protects bank safety and soundness. Chairman Helfer of the FDIC testified in 1997:

> "From a safety and soundness standpoint, both the holding company model and the bank subsidiary model are viable approaches to expanding the powers of banking organizations. The safeguards that are necessary to protect the insurance funds are similar for either structure. If these safeguards are in place and enforced, either approach will work to protect the insured bank and the deposit insurance funds.
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> "[A]llowing banks to generate earnings from activities in bank subsidiaries lowers the probability of failure. Earnings from bank subsidiaries provide greater protection for the insurance funds than do earnings from activities in bank holding company

affiliates, because the earnings of the subsidiary accrue to the benefit of the insured bank parent. This is because diversification often leads to less volatile earnings."[1]

FDIC Chairman Tanoue likewise emphasized the value of the subsidiary: When the bank "is financially troubled and the affiliate/subsidiary is sound, the value of the subsidiary serves to directly reduce the exposure of the FDIC. Thus, the subsidiary structure can provide superior safety and soundness protection."[2]

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5. Insofar as a bank may receive a federal subsidy through deposit insurance and the payment system, could the bank transfer the subsidy more readily to a subsidiary than to an affiliate?

No. The safety and soundness protections described above (Question 3) would eliminate any economic difference between conducting an activity in a subsidiary and conducting it in an affiliate (apart from such benefits of the subsidiary as better protecting the FDIC and diversifying the bank's earnings). Thus, if a subsidy exists, the bank could not transmit it any more readily to a subsidiary than to an affiliate. Every dollar that the bank could invest in a subsidiary could as readily be paid out as dividends to the holding company in order to capitalize new affiliates. (And the limits on a bank's loans, guarantees, and asset purchases would be exactly the same for a subsidiary as for an affiliate.) There is no evidence that money paid upstream to affiliates would carry any less of a subsidy than the same funds invested downstream in an subsidiary.[3] And the bank's ability to provide such funds would be the same for affiliates as for subsidiaries: the bank could not make an equity investment in a subsidiary that exceeded the amount it could pay in dividends; and the bank would have to remain well-capitalized after deducting the capital invested in the subsidiary or channeled as dividends to the holding company.

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[1] Testimony of Ricki Helfer, Chairman, FDIC, Committee on Banking and Financial Services, U.S. House of Representatives, May 22, 1997.

[2] Testimony of Donna Tanoue, Chairman, FDIC, Committee on Banking, Housing, and Urban Affairs, United States Senate, June 25, 1998.

[3] The Federal Reserve has argued that dividends paid by banks have largely ended up in the hands of shareholders (as holding company dividends), rather than being used to capitalize new affiliates. But this does not indicate what would happen if bank holding companies could have broad new activities and affiliations. If a material safety net subsidy existed and could be transmitted, holding company management would have strong incentives on behalf of shareholders to utilize bank resources to capitalize new affiliates.

A recent article published in the Federal Reserve Bank of Richmond's *Economic Review* notes that the bank could transfer subsidized funding to the affiliate as follows:

> "Banks could pass along subsidized funding through dividend payments. Here's how. A bank could gather funds at subsidized rates and pass them to its affiliates and subsidiaries by paying dividends to the parent [bank holding company]. The parent might then pass the funds on to bank affiliates and subsidiaries by purchasing debt of these entities or through equity investments in them. In this way funds raised at subsidized rates could leak out to affiliates and subsidiaries and be substituted by the affiliate for more expensive, unsubsidized funding sources.
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> ". . . While . . . limits [on dividend payments] might somewhat restrict the efficacy of dividends as a means of subsidy transfer, they cannot completely forestall such use. For a bank that is larger than its affiliated nonbank, the [applicable limit] may amount to a large portion of the nonbank's liabilities. Consequently, the bank could provide a significant share of the affiliate's funding."[4]

One might question whether a net subsidy of any significance actually exists.

- If a measurable subsidy existed, firms that include banks would tend to locate activities under the bank to reap a competitive advantage. Yet where such firms are free to choose their organizational form, no clear pattern emerges.
    - For example, mortgage banking operations can be conducted in the bank, in subsidiaries of the bank, or in holding company affiliates. Of the top 20 bank holding companies, 6 currently conduct mortgage banking activities in an affiliate, 9 conduct such activities in the bank or in a subsidiary of the bank, and 5 use a combination of bank and affiliate. This pattern suggests either that any net subsidy is minimal, or that it is the same for both sorts of organizational arrangements.

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[4] Walter, John R., "Can a Safety Net Be Contained?," Federal Reserve Bank of Richmond *Economic Quarterly*, Volume 84/1 Winter 1998, p. 12.

Note that the holding company and its shareholders stand to benefit from any subsidy of the bank regardless of whether the bank ever "transfers" that subsidy anywhere else. Shareholders can accept a smaller return from the holding company's investments in units not funded by the bank in exchange for a higher return on the holding company's investment in the bank.

- In addition, if a safety net subsidy were substantial and created a competitive advantage, banks (even more than their subsidiaries) would tend to dominate the market in activities that they can conduct within the bank. But this has not been the case. For example, banks do not dominate the government securities markets, even though banks are free to underwrite and deal in those securities.

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6. Would generally accepted accounting principles lead banks to prop up troubled subsidiaries?

Banks do submit "call reports" to regulators that consolidate the bank's financial statements with those of its subsidiaries, as generally required under GAAP. But accounting principles do not determine a bank's exposure to a subsidiary and do *not* justify limiting the subsidiary's activities.

- *Accounting does not dictate liability.* A parent corporation is not generally liable for the obligations of a subsidiary (as discussed above in connection with Question 3) — regardless of whether the assets of the parent and subsidiary are consolidated for accounting purposes.

- *The most heavily relied upon, publicly reported GAAP-based financial statements are those of the bank holding company,* which consolidate the financial statements of the bank with those of all affiliates as well as all subsidiaries. *Thus if banks have a GAAP-induced incentive to prop up subsidiaries, banks have the same incentive to prop up affiliates*, and bank holding company financial statements that reflect an affiliate's poor performance could just as easily concern investors and depositors.

- Although it is true that losses of a subsidiary would appear in a bank's GAAP-based financial statements, these losses would disappear from the bank's balance sheet when the subsidiary was liquidated or sold. At that point, the bank's financial statements would again reflect its actual economic loss, which would not exceed the bank's equity investment (for which it has already taken a capital deduction and still remained well-capitalized) and credit exposure within section 23A limits.

- Regardless of a bank's inclination to support a troubled subsidiary, the Treasury's approach would constrain the bank from doing so. The bank could not make any equity investment without deducting that investment from its own capital and remaining well capitalized after the deduction. As required by amended sections 23A and 23B, any loan, guarantee, or asset purchase would have to be fully collateralized and on market terms, and could not exceed 10 percent of the bank's capital.

7. *Are some proposed financial activities so inherently risky as to be inappropriate for subsidiaries?*

The notion that banks conduct safe "banking" activities whereas other financial service providers conduct dangerous "nonbanking" activities is antiquated, as Chairman Greenspan has explained:

> "[T]he pressures unleashed by technology, globalization, and deregulation have inexorably eroded the traditional institutional differences among financial firms. . . . On the bank side, the economics of a typical bank loan syndication do not differ essentially from the economics of a best-efforts securities underwriting. Indeed, investment banks are themselves becoming increasingly important in the syndicated loan market. With regard to derivatives instruments, the expertise required to manage prudently the writing of over-the-counter derivatives, a business dominated by banks, is similar to that required for using exchange-traded futures and options, instruments used extensively by both commercial and investment banks. The writing of a put option by a bank is economically indistinguishable from the issuance of an insurance policy. The list could go on. It is sufficient to say that a strong case can be made that the evolution of financial technology alone has changed forever our ability to place commercial banking, investment banking, insurance underwriting, and insurance sales into neat separate boxes."[5]

8. *Do American banks have experience conducting nonbanking activities through subsidiaries?*

Yes. Subsidiaries of U.S. banks have for years engaged overseas in investment banking and merchant banking — safely, soundly, and with Federal Reserve approval.[6]

These subsidiaries, which operate under the Edge Act, can be extremely large. For example, one such subsidiary has over $73 billion in assets, or approximately 28 percent of the total assets of the bank and its subsidiaries.

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[5] Remarks by Chairman Alan Greenspan at the Annual Convention of the American Bankers Association, Boston, Massachusetts, October 5, 1997.

[6] Since 1979, the Fed's Regulation K has permitted foreign subsidiaries of both U.S. banks and bank holding companies to underwrite and deal in *equity* securities outside the United States. Foreign subsidiaries of U.S. banking organizations have, for over 25 years, had broad authority to underwrite and deal in *debt* securities.

Overseas subsidiaries are subject to less stringent safeguards than the Treasury would apply to U.S. subsidiaries of banks. The Fed generally does not apply to Edge Act subsidiaries the restrictions of sections 23A and 23B (such as the 10 and 20 percent limits described above in response to Question 3), and H.R.10 would continue that practice. Thus a bank's loans to an Edge Act subsidiary could exceed 100 percent of the bank's capital.[7]

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9. Did the thrift debacle result from allowing new financial activities in subsidiaries?

The thrift debacle had multiple causes, and resulted in part from allowing insolvent or weakly capitalized insured depository institutions to expand rapidly into risky new activities for which they had little or no experience (including nonfinancial activities like real-estate development). Far from having to remain well-capitalized, thrifts faced no effective capital discipline, and were commonly in poor financial condition. No capital deduction requirement applied. Since thrifts had little or no real capital of their own, they essentially funded their investments with insured deposits. And far from being well-managed, thrifts were ill-equipped to manage the risks involved.

By contrast, under the Treasury's approach a bank must deduct from its own capital its entire equity investment in a subsidiary, and must remain well-capitalized even after the deduction. In effect, the bank must fund every dollar invested in the subsidiary with money that could otherwise go to its own shareholders. And the bank must remain well managed, which includes having internal controls adequate for the risks it faces.

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10. Do bank holding companies face higher borrowing costs than their banks?

A bank holding company's debt generally has a lower credit rating than comparable debt issued by the banks owned by that holding company. Thus the holding company faces correspondingly higher borrowing costs than its banks. Some cite these differences as proof that the bank cannot transfer any safety net subsidy to the holding company. But the differences prove nothing of the sort. We have already explained (in response to Question 5) why a bank can transfer any subsidy just as readily to an affiliate (or holding company) as to a subsidiary. And, as we will now explain, the differences in credit ratings and borrowing costs reflect the typical bank holding company's reliance on its banks' assets and earnings — and its vulnerability to any regulatory action curtailing the bank's dividends.

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[7] Some restrictions do apply. For example, certain portfolio investments could not exceed the bank's tier 1 capital. 12 C.F.R. § 211.5(b)(iii)(A)(2). Certain commitments to underwrite equity securities could not exceed specified percentages of capital, and the bank would have to be able to remain well capitalized after deducting from its capital commitments exceeding those limitations. 12 C.F.R. § 211.5(d)(14)(ii).

A holding company with debt outstanding commonly relies on dividends from the bank for the cash it needs to service that debt. If the bank gets into financial trouble, regulators often curtail dividend payments by the bank.[8]

The credit rating and cost of holding company debt reflects the additional risk of such a dividend cut-off. It also reflects the inferior position of holding company debt if the bank fails. In any such failure, holding company debt holders would be paid only out of money remaining after the FDIC, uninsured depositors, and all other creditors of the bank were paid in full.[9]

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11. Is allowing new financial activities in subsidiaries consistent with functional regulation?

Absolutely. We support nondiscriminatory functional regulation of securities and insurance activities, regardless of whether these activities are housed in subsidiaries or affiliates of banks. The SEC would have the same authority over a broker-dealer that was a subsidiary of a bank as it would over a broker-dealer affiliate of a bank holding company. State insurance commissioners would have the same authority over an insurance company owned by a bank as they would over any insurance company owned by the bank's parent holding company.

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12. What about the risk of a future Congress loosening applicable safeguards?

Any such risk would be no greater in the case of subsidiaries than in the case of affiliates.

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[8] Moreover an undercapitalized bank cannot pay dividends at all. 12 U.S.C. § 1831o(d)(1)(A).

[9] By contrast, debt holders of the *bank*, although they would be paid only after the FDIC and other depositors, would be on a par with most of the bank's remaining creditors.